Entrepreneurial success, social capital and microfinance

Postelnicu, L.; Hermes, Cornelis

Published in:
Passerelles: Revue de liaison entre le monde de la recherche et le terrain

Publication date:
2016

Entrepreneurial success, social capital and microfinance

Luminita Postelnicu and Niels Hermes

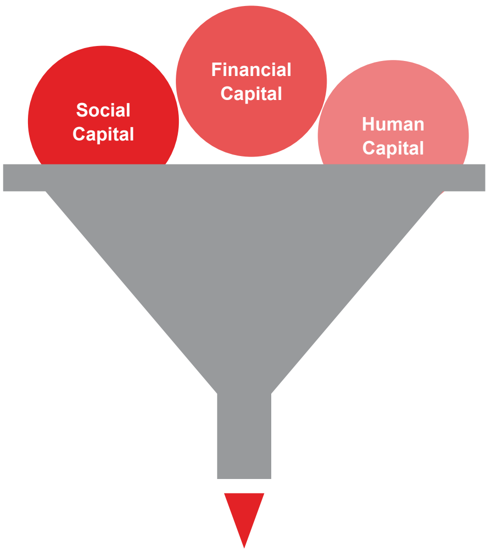
Luminita Postelnicu

Luminita Postelnicu is a Data Scientist specialized in customer analytics. She is responsible for the marketing research projects at Mentis Consulting SA. She holds a PhD in Economics, and her current research is focused on marketing strategy optimization. Past research includes microfinance, and in particular the role of social capital in joint liability group lending.

The success of entrepreneurial activities is determined by three types of capital: financial capital, human capital and social capital. Financial capital ensures the assets needed by entrepreneurs to start and run their businesses. Human capital refers to the set of skills, knowledge and experience that can be transformed into labor and, thus, into economic value. Social capital refers to the resources embedded in social ties – that is, who one knows, what information advantage those one knows can provide, and the extent to which one's connections are able and willing to help in case of need.

Individuals living in environments characterized by poor formal institutional frameworks and scarcity of resources usually lack financial capital and valuable human capital. Social capital is the only form of capital they can build themselves in such environments. This particularly holds for individuals living in rural areas. Financial institutions have usually lower coverage in rural areas, which makesborrowing difficult, even for individuals that would otherwise be creditworthy. Moreover, restricted access to new information and low quality of educational facilities reduce the opportunity for rural individuals to build valuable stocks of human capital. How can individuals living in these environments still become successful entrepreneurs?

Figure 1: Success of Entrepreneurial Activities



The starting point for how social capital can be important for entrepreneurs lacking financial and human capital is the notion that individuals usually share several ties with other individuals within (and possibly even also outside) the community (i.e. the village, neighborhood, etc.) in which they live. These ties form his/her social network. Social networks are patterns of social exchange and interaction that persist over time. Social ties embed access to tangible and non-tangible resources (e.g. trust, reciprocity and mutual support). These resources enable individuals to use these ties as informal risk insurance devices, that is, in case of need they can make use of these resources to overcome crisis situations. At the same time, ties can be used to collect information available within the network. Since two individuals are linked to each other through a tie, they may know about each other's behavior and this information may be shared with other members in the network of both individuals. The more the networks of two individuals overlap, the higher the potential of information getting diffused to other network members of both individuals. This is referred to as ties having information diffusion potential. The resources embedded in the ties, together with their information diffusion potential, make up the individual's social capital.

The fact that individuals have access to social capital may help them getting access to financial and human capital. Since the mid-1970s microfinance has been introduced as a financial innovation that enables poor entrepreneurs to have access to financial capital and human capital

Niels Hermes

Niels Hermes is Professor of International Finance, Faculty of Economics and Business at the University of Groningen, The Netherlands, Visiting Professor at the Université Libre de Bruxelles, and Associate Researcher of the Centre for European Research in Microfinance, Solvay Business School at Université Libre de Bruxelles. He is also Director of the MSc Finance and the MSc International Financial Management at the University of Groningen. His research focuses, among other things, on microfinance, the impact of financial liberalization and foreign banking.

“

The fact that individuals have access to social capital may help them getting access to financial and human capital.

(e.g. when borrowing is combined with training programs, such as business training, financial training and other related training programs) by pledging their stocks of social capital as collateral.

Several different social capital based lending methodologies have emerged around the world. One of the most common methods is the so-called group lending model with joint liability. Group lending with joint liability gives access to credit as well as non-financial services (financial literacy, business trainings, education, health services, etc.) to groups of poor entrepreneurs. The main feature is that group borrowers are jointly liable for the repayment of each other's loans. This incentivizes them to use their social ties to screen and monitor their peers, to help with loan repayment in case of economic default, and to enforce repayment on delinquent group members.

Other common micro-lending methodologies that rely on social capital are village banks, community-managed savings and loan programs, and individual microloan programs. The latter one is a lighter form of social capital based lending in the sense that it still relies on social capital (that is, repayments are made in groups and in public areas, social relationships are identified and assessed by the loan officer, and in most of the cases guarantors are required), but it does not have the joint liability feature.

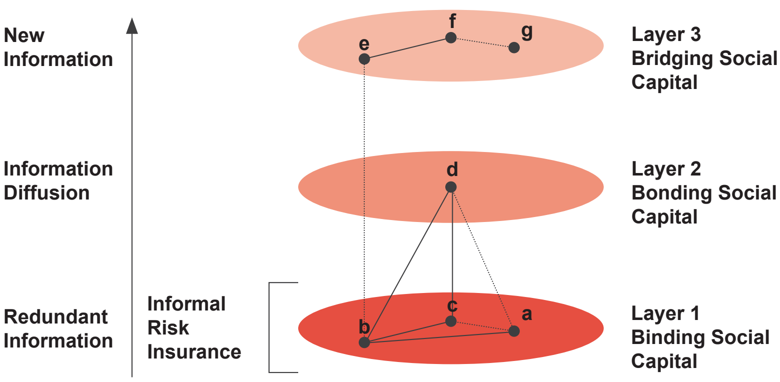
The stock of social capital of poor entrepreneurs may determine their success in repaying loans. Socio-economic theory suggests that the individual stock of social capital is typically structured in three layers.

The figure below describes the social capital of individual/borrower ‘a’ in three layers. The first social capital layer (so-called binding social capital) is formed by a's strong ties (that is, family members and very close friends). These ties act as his/her informal risk insurance arrangement; they are borrower a's “safety net”, because individuals who are part of the first layer may help the borrower with financial and non-financial resources in case of need. The second social capital layer, known

as “bonding social capital”, is formed by weaker ties to the friends of friends or the friends of family members. These individuals may interact with the borrower, but may not necessarily be willing to support her/him in case of need. The third layer, called “bridging social capital”, refers to the entire community in which the borrower lives. Bridging social capital provides a borrower with a sense of belonging to the other members of the community even though they may not interact directly. When ties with the third network layer exist, they are always weak, that is, individuals belonging to this layer will most likely not support the borrower with resources during bad periods.

So, the ties forming the second and third network layer do not act as informal risk insurance devices, but they do give access to new information, that is, information that cannot be obtained from the members of the first network layer. What members of this first layer know is also known by the borrower, because of their close relationship. When it comes to providing new information, bridging ties are the most important, because they have access to information the borrower may not know. Having access to new information is important for entrepreneurs to become successful as it improves knowledge and gives access to new opportunities. Unfortunately, individuals living in rural areas usually lack the third network layer. They rely on their first network layer to cope with idiosyncratic shocks, but they typically lack access to new information. The information diffused within their

Figure 2: The three layers of social capital



networks is mostly redundant. While the stock of social capital accumulated by rural individuals in the first and the second network layer can be effectively used as social collateral in microlending, lack of access to information renders more difficult the access to new business opportunities.

In this sense, past research has shown that, indeed, poor entrepreneurs may become successful when they have access to microfinance. Their access to social capital enables them to successfully repay their loans by pledging their strong ties (i.e. the ties forming their first network layer) as collateral. At the same time, however, lack of access to new information and new opportunities, which is typically a problem for entrepreneurs living in rural areas, may hamper their business performance.

A large study we carried out among clients of Pro Mujer Mexico[1] and with the financial support of ADA reveals how the social capital of micro-entrepreneurs may be helpful for successful loan repayment. We explore an original dataset containing 802 mapped social networks of borrowers from Pro Mujer Mexico. We have two main findings. First, borrowers with stronger informal risk insurance arrangements are in better economic shape and have a higher capacity to pay than borrowers with weaker informal risk insurance arrangements. Second, borrowers who pledge valuable ties as social collateral have fewer repayment problems. These results suggest that social capital can be used as an effective device to ensure the microfinance success.

So, to conclude, successful microcredit programs reduce credit constraints for poor micro-entrepreneurs. Moreover, these programs may help them improve their stocks of human capital, especially when access to finance is combined with training programs, which are focused on helping these entrepreneurs to improve on their business and financial skills.

1 See bibliography.

SUCCESS STORY

Financing young entrepreneurs in Togo

Working together with partner MFIs, the aim of ADA's project Young Entrepreneurs is to put in place financial services (loans and saving) and non-financial services (training, financial education, advice on company management, follow-up and support), that are adapted to the needs of young entrepreneurs wishing to start up a micro-enterprise or to expand it.

In Togo, the first micro-credits were disbursed in mid-December 2015 by FUCEC and by the end of February 2016, FUCEC had financed 115 young Togolese for an amount of 44 420 900 CFA (67 719 €), seven of whom received two credits: one for their activity's working capital and one for investment. This adds up to a total of 122 disbursed credits.

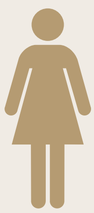
Twenty four of these young clients have been financed in order to help them to start up their activity (financing both equipment and working capital), for a total of 11 353 900 CFA (approximately 17 310 €).

Furthermore, 33 067 000 CFA (50 410 €) have been disbursed to 91 young people who have been able to use this money to boost their activity. Sixty six of these credits have been used to purchase equipment (24 513 000 CFA – 37 370 €) and 32 credits have been used to bolster working capital (8 554 000 CFA – 13 040 €). Almost half (46%) of the young Togolese who have received funding live in Lomé, the capital of Togo and more than half (52%) of the young people financed by the project are women.

For more information, please visit our website.

By the end of February 2016
44 420 900 CFA (67 719 €)

were disbursed to
115 young people



52%
of the young people financed by the project are women.

Bibliography

Recent trends in agricultural finance: new approaches to address and overcome main barriers and challenges.

FAO (2012): *The State of Food and Agriculture 2012: Investing in Agriculture for a Better Future*, Rome: FAO.

Hernandez, Emilio (2015): *Agricultural Finance: Opportunities, Emerging Models and Product Design.* Lecture prepared for the Boulder Microfinance Training.

Ligon, Ethan; Sadoulet, Elisabeth (2007): “Estimating the Effects of Aggregate Agricultural Growth on the Distribution of Expenditures”, in: *The World Development Report 2008*.

Saving drops of water and nurturing life: financing arboriculture projects and irrigation systems in rural Morocco.

EL Khoumsi, Wafae; Hammani, Ali; Kuper, Marcel; Bouaziz, Ahmed (2014): “Deterioration of Groundwater in Arid Environments: What Impact in Oasis Dynamics? Case Study of Tafilalet, Morocco”, in: *International Journal of Environmental, Chemical, Ecological, Geological and Geophysical Engineering,* 8 (11).

Ghanem, Hafez (2015): “Agriculture and Rural Development for Inclusive Growth and Food Security in Morocco”, in: *Global Economy and Development,* Working Paper 82, February 2015.

Planting the seeds of inclusion: An alternative pathway for coffee production

Asamblea Nacional (2013) *Ley 853 para la transformación y desarrollo de la caficultura.* Managua, Nicaragua.

Bastiaensen, Johan; Huybrechs, Frederic; Forcella, Davide; Van Hecken, Gert. (2015): “Microfinance Plus for Ecosystem Services: A Territorial Perspective on Proyecto CAMBio in Nicaragua”, in: *Enterprise Development and Microfinance*, 26 (3).

Chamorro, Luis Alberto (2015): *El rol de cisa exportadora en la cadena del café*, interview by Flores, Selmira; Polvorosa, Juan Carlos.

Huybrechs, Frederic; Bastiaensen, Johan; Forcella, David; Van Hecken, Gert (2016): “La microfinance pour les services environnementaux. Enseignements en matière de politiques du Proyecto CAMBio au Nicaragua”, in: *Revue Tiers Monde. L’inclusion financière: aider les exclus ou servir les financiers?*, 225 (1).

IPCC (2014): *Cambio climático 2014: Informe de síntesis. Contribución de los Grupos de trabajo I, II y III al Quinto Informe de Evaluación del Grupo.* Ginebra: IPCC.

Kaplinsky, Raphael; Morris, Mike (2001): *The Handbook of Value Chain.* London: Institute of Development Studies. Available online: https://www.ids.ac.uk/ids/global/pdfs/VchNov01.pdf.

Laderach, Peter; Schepp, Kathleen; Ramirez, Julian; Jarvis, Andy; Eitzinger, Anton (2010): “Impacto del climate change para el cultivo de café en Nicaragua”, in: Martinez-Alonso, Celia; Locatelli, Bruno; Vignola, Raffaele; Imbach, Pablo (Eds.): *Adaptación al cambio climático y servicios ecosistemicos en América Latina,* Serie técnica, Manual técnico, 99, pp. 54-64.

Laderach, Peter; Zelaya, Carlos; Ovalle, Oriana; Garcia, Samuel; Eitzinger, Anton; Baca, María. (2012): *Escenarios del impacto del clima futuro en áreas de cultivo de café en Nicaragua.* Colombia: Cali.

Maldidier, Cristóbal (2015): *Infome global de la sistematizacion de los ejes del plan estrategico de Nitlapan.* Managua: Nitlapan.

Marin, Yuri; Paiz, Francisco; Munguia, Carlos (2015): *Evaluacion de la asistencia tecnica a la cartera cafetarlera del FDL.* Managua: Nitlapan.

Mendoza, René (2013): “El café en los tiempos de la roya”, in: *Envío Digital*, 372.

Mojica, Carlos. (2014): *Plan de Desarrollo Económico Local del municipality de El Tuma La Dalia, Matagalpa 2014-2018.* La Dalia: Alcaldía Municipal.

Salinas, Karen; Acuña, Noyling; Castillo, Beverly (2015): “Proceso de producción para la exportación de café de calidad al mercado internacional por parte de la empresa CISA Exportadora en el período 2014-2015”, in: *Revista Científica de FAREM-Estelí. Medio ambiente, tecnología y desarrollo humano*, 16, pp. 23-34. Available online: http://revistasnicaragua.net.ni/index.php/RCientifica/article/view/2046/1972

Sievers, Merten; Vandenberg, Paul (2007): “Synergies through linkages, who benefits from linking micro finance and business development services?”, in: *World Development*, 35 (8).

Solórzano, Julio; Cáceres, Félix (2012): *Programa de Mejoramiento Productivo de la Coffee production para pequeños y medianos productores.* Managua: FUNIDES.

Entrepreneurial success, social capital and microfinance

Postelnicu, Luminita **;** Hermes Niels (2015) : “Microfinance Performance and Informal Institutions: A Cross-country Analysis”, *Working Papers CEB,* 15-032. Brussels: ULB-Université Libre de Bruxelles.

Postelnicu, Luminita **;** Hermes Niels; Servin Roselia (2015): “Social Capital and the Repayment of Microfinance Group Lending. A Case Study of Pro Mujer Mexico”, *Working Papers CEB,* 15-023. Brussels: ULB-Université Libre de Bruxelles.

Postelnicu, Luminita **;** Hermes Niels; Szafarz, Ariane (2013): “Defining Social Collateral in Microfinance Group Lending”, *Working Papers CEB,* 13-050. Brussels: ULB-Université Libre de Bruxelles.